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# Testing a model of UK growth: a role for R&D subsidies

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R&D is a main driver of growth, whether by generating new ideas for production or increasing technological transfer. However, R&D itself is risky and faces numerous barriers which may reduce its marginal return. Direct R&D subsidies are intended to counteract such barriers, but whether they lead empirically to increased economic growth is unclear. In our structural model of the UK, subsidies offset the frictional costs associated with R&D, incentivising innovation and so stimulating productivity growth. We estimate and test this structural model by indirect inference, a method not previously used in work on R&D. We find that even temporary cuts to R&D funding have long-lasting impacts on UK economic growth. The power of the test allows us to calculate tight accuracy bounds for our results and for policy reform impacts calculated using the model. These findings are of high relevance to the ongoing debate around the future UK innovation environment.

JEL Codes: E00 O00 O38 O50

Keywords: R&D, economic growth, Total Factor Productivity (TFP), UK, indirect inference, DSGE

## 1. INTRODUCTION

Have government subsidies to private sector research and development boosted UK growth over the past four decades? That is the question tackled in this paper. Starting with Schultz (1953) and Griliches (1958), an influential literature links R&D activity to economic growth, and the R&D growth channel is now taken as given by many. However, at the macroeconomic level the causal link between direct subsidies, R&D and successful innovation remains less empirically certain.

This paper therefore takes an empirical look at a structural model which embeds that key growth hypothesis. The research question is whether direct government R&D subsidies have incentivised the private sector to conduct R&D, and so enhanced innovation and productivity

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growth in the UK over the sample (1981-2010). To answer it we use indirect inference (Le et al., 2011), a powerful and relatively new method which has not yet been applied to the question of R&D subsidy effectiveness.

Private sector R&D is the observable counterpart of the profit-motivated innovation efforts long identified as a driver of technological progress, both by generating ideas for new products and processes directly (Romer, 1990; Aghion and Howitt, 1992) and by raising an economy's absorptive capacity for ideas generated abroad (Griffith et al., 2003).

Intuitively, subsidies to private R&D should encourage that activity at the margin. The theoretical motive for this government intervention is that projects of high value to society would not be funded by the private sector otherwise (Arrow, 1962; David et al., 2000). This might be because important, paradigm-shift innovations: i) have high upfront costs, ii) are risky with high chance of failure, making capital more difficult to raise relative to other activities (Bournakis and Mallick, 2018), and iii) on arrival their returns spill over costlessly to competitors, due to the non-rival and partially non-excludable nature of ideas. The prediction is that R&D subsidies will raise aggregate productivity growth by correcting private R&D incentives, which are otherwise too low for these reasons.<sup>3</sup> The theoretical literature is discussed further in Section 2.

Direct support for business R&D is a key plank of the UK government's industrial strategy, so the policy relevance of this question continues to be high (HM Government, 2017). The importance of direct R&D subsidies to the private sector is the subject of continuing debate, however, for several reasons. R&D policy programmes represent a considerable outlay of public money, but do they actually generate growth? Problems arise when it comes to testing the effectiveness of these policies. First, innovation itself is difficult to measure. R&D expenditures and patent counts are convenient measurable proxies for innovation outputs in empirical studies, but how far they capture innovation is questionable (Danguy et al. 2014). Firms may patent as a signal to capital markets or to earn through licensing revenues, for instance, a non-innovative activity. Increased R&D expenditures due to subsidies may also be channelled straight into researcher wage increases, since researcher supply is relatively inelastic (Goolsbee, 1998). Finally, governments may be bad at 'picking winners' if there is information asymmetry.<sup>4</sup> These theories would predict little relation between direct R&D subsidies and

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<sup>3</sup>For empirical estimates of private and social rates of return, see Hall et al. (2010).

<sup>4</sup>Hence the increasing use of R&D tax credits; see OECD (2016) and references therein; also Alvarez-Ayuso et al. (2018).

aggregate innovation.

The theoretical ambiguity just outlined is not easily resolved empirically, because it is difficult to test the causal impact of R&D subsidies on innovation and aggregate productivity growth econometrically. See Becker (2015) for a brief discussion of the methodological issues, as well as a survey of recent empirical work on R&D policy effectiveness.<sup>5</sup>

This paper therefore takes a structural modelling approach, examining the aggregate impact of direct R&D subsidies within an identified macroeconomic model of the UK: a Dynamic Stochastic General Equilibrium (DSGE) model economy.<sup>6</sup> Taking an open economy model which has been shown elsewhere to account well for the UK macroeconomy’s behaviour (Meenagh et al., 2010), we add an unambiguous role for direct R&D subsidies which affect innovation incentives at the microfoundation level. Individuals weigh up the gain from innovation (R&D) against the cost of not working in regular labour; the subsidy enters this trade-off by raising the marginal return to R&D (effectively by lowering associated costs which distort the R&D decision). That choice in turn implies a systematic relationship from R&D subsidies to productivity which drives the model economy’s behaviour. More specifically, temporary R&D policy shocks generate medium-term growth episodes; like Comin and Gertler (2006), we investigate both short and medium-term business cycle dynamics.

Our key contributions lie in estimating and empirically testing this microfounded model by indirect inference methods (Le et al., 2011, 2016). This is a statistically powerful test which rejects misspecified models sensitively, as we establish in the paper using Monte Carlo methods (cf. Le et al., 2016). The exercise allows us to construct uncertainty bounds around our estimates and around the quantitative conclusions derived using the model. When we present the growth impact of a simulated policy reform in Section 4 below, we can then also give a clear indication of the accuracy of the results. We also test the DSGE model’s identification, applying the numerical identification test proposed in Le et al. (2017).

For this reason, the present paper is a useful complement to existing empirical work on the macroeconomic impact of direct R&D subsidies. By estimating the DSGE model and testing it in this way, the conclusions cannot be said to rely on an untested calibration.

Further value of the approach taken here lies in the ability to specify a particular causal

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<sup>5</sup>e.g. macroeconometric regressions (e.g. Bloom et al. 2002) suffer from potential omitted variable bias, as R&D policies can be correlated with unobservable drivers of (or obstacles to) innovation. Such econometric models are essentially reduced forms in which one theory cannot be easily distinguished from another with quite different implications (the identification problem).

<sup>6</sup>The model assumes households and firms follow their economic interests in the face of economic shocks, subject to market disciplines as assumed in standard economics and allowing for costs of adjusting over time.

mechanism for growth in the DSGE model; hence there is no question surrounding the exogeneity of policy in the model. For instance, there is no possibility in the model of reverse causality such that R&D policy actually responds to growth or to omitted growth drivers, rather than being a growth determinant itself. This approach therefore bypasses difficulties associated with potential regressor endogeneity which are so hard to address conclusively in macro-level regressions (Becker, 2015), while retaining the idea that hypotheses can be tested by classical econometric methods (an idea that receives less attention in the DSGE literature).

Another advantage is that we can look at a single country, the UK, without imposing homogeneity assumptions across a sample of countries which may actually differ in the relationship between R&D subsidies and growth.

We find robust evidence in this paper of a positive impact of shocks to direct R&D subsidies on the path of Total Factor Productivity (TFP) and output. The results of our test suggest that increases in R&D subsidies generate medium term growth episodes. Simulating the estimated model shows that a one-off, temporary increase in R&D subsidies of 0.01 above trend leads to an average higher growth rate of 0.11 percentage points per annum over nearly two decades (70 quarters). Our power exercise implies the uncertainty interval for this average growth rate impact is (0.06, 0.17) percentage points per annum.

A review of some existing literature on R&D-driven growth is given in Section 2, focusing on the macroeconomic literature. Section 3 outlines the DSGE model including the growth process. Empirical work follows in Section 4, including an outline of the methodology and data, estimation results and a variance decomposition for the estimated DSGE model. We also report the results of our Monte Carlo exercise on the power of the testing method applied here, as well as simulation results for a controlled temporary R&D policy reform using the estimated model. Section 5 concludes.

## 2. LITERATURE

In the New Endogenous Growth theory, spillovers overcome diminishing returns to accumulable factors in the aggregate production function, generating sustained economic growth. They also undermine private incentives to innovate since the innovator cannot appropriate the full return from his investment (e.g. Aghion and Howitt, 1992; Romer, 1990). Supposing that a downward incentive effect dominates, the broad flavour of policy recommendations coming out of these models is that research activities should be subsidised directly — or indirectly

through fiscal incentives — in order to bring private returns into line with the social rate, and that protection of intellectual property rights should be increased, enabling the innovator to appropriate more of the returns to his investment despite the non-rivalry of knowledge outputs. The underlying structure of the environment can also play a role, depending on the particular model; competition policy and the reduction of barriers to entry and other market frictions may increase the innovation rate (see discussion in Aghion et al. 2013).

Pure endogenous growth models in the style of Romer (1990) predict large long-run growth responses to changes in the scale of the economy’s R&D sector; but while R&D activity (in terms of labour inputs and investment) increased dramatically in the last century, long-run growth rates were largely stable. Since Jones (1995), a second generation of ‘semi-endogenous’ R&D-driven growth models has emerged which imply a weaker scale effect, allowing R&D and policies incentivising it to have important transitional effects on growth but not to determine the long-run. The choice of semi- versus fully endogenous growth mechanism can imply significantly different optimal R&D tax and subsidy policies; see Sener (2008) for discussion. We discuss semi-endogenous growth, given our own empirical focus on the transitional growth effects of R&D policy.

A number of existing DSGE models explore the macroeconomic impacts of R&D policies by simulation, embedding a semi-endogenous R&D-driven growth mechanism and making additional modelling choices which offer various insights. For instance, policymakers may increase innovation through the R&D channel by subsidising human capital accumulation, exploiting complementarities between the two activities that arise through the use of highly skilled workers as an input to the R&D process. This complementarity is modelled in Papageorgiou and Perez-Sebastian (2006) and explored in Varga and t’Veld (2011) among others. Cozzi et al. (2017) take a Schumpeterian approach in which the technology frontier evolves semi-endogenously, combining creative destruction with price stickiness.

McMorrow and Roeger (2009) examine the impact of R&D policy on growth in a global DSGE model calibrated to the EU and to the US. They add the semi-endogenous growth mechanism in Jones (1995) to the European Commission’s QUEST III model (Ratto et al. 2009), finding that subsidies to R&D make only a modest contribution to productivity growth. The supply of high-skilled workers is constrained so the subsidy impact is largely absorbed by increases in researcher wages (cf. Goolsbee, 1998). Of course the overall impact is constrained by the semi-endogenous growth assumption. In the short run there is reallocation of high-skilled

labour from the production sectors to the research sector, which dampens output directly following the reform (this is the case in the model we propose as well).

A key issue in such models is calibration of the R&D externality parameter.<sup>7</sup> This is generally either set based on the panel econometric literature or set indirectly by other parameter choices, themselves calibrated to results from econometric studies (e.g. Papageorgiou and Perez-Sebastian, 2006). McMorrow and Roeger (2009) calibrate externalities to panel regression estimates from Bottazzi and Peri (2007) and Coe and Helpman (1995). Bye et al. (2011) use a CGE model of a small open economy calibrated to Norway to simulate innovation policy reforms; while they calibrate the growth process from econometric results, they note that estimates are scarce for their purposes and rely heavily on sensitivity tests. Of course the simulated policy impacts produced from calibrated DSGE models depend strongly on calibration choices. The difficulties of interpretation posed by macro-level regressions of growth or productivity on policy variables are well known — causality is hard to establish and the scarcity of strong, exogenous instruments for potentially endogenous regressors leaves such regressions prone to bias.<sup>8</sup> We therefore opt not to calibrate the growth process in our model from this literature, given that the magnitude of the parameter on R&D policy is pivotal for our conclusions.

Other notable papers in this literature are Comin and Gertler (2006) and Comin et al. (2009). Against a US real business cycle backdrop they use a modified expanding varieties mechanism for technological change but add a role for technology absorption, where absorption is costly. Though some parameters are estimated using Bayesian methods, the technological parameters are still calibrated from econometric studies: Comin and Gertler (2006) readily acknowledge the difficulty of calibrating these parameters and that estimates are "crude" (p.541).

Cozzi et al. (2017) estimate structural parameters for a New Keynesian creative destruction model of the US using Bayesian methods, including the parameters featuring in the growth process. The structure of their model differs from ours, but we note their relatively high estimate of the intertemporal knowledge spillover parameter. This implies that shocks affecting R&D intensity will have long-lasting macroeconomic effects. They also find a high persistence

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<sup>7</sup>Where international spillovers are included there is both a domestic R&D externality parameter and an international externality to be calibrated.

<sup>8</sup>Macro-regression studies are often defended on the grounds that “they help us update our priors about the impact of certain types of policies” (Rodrik, 2012, p. 141) and that “even simple or partial correlations can restrict the range of possible causal statements that can be made” (Wacziarg, 2002, p. 909), but when models are not identified it is not clear that this is defensible.

for exogenous R&D policy shocks, consistent with our own results below. For other more recent contributions using a mixture of Bayesian estimation and calibration see Anzoategui et al. (2017) and Bianchi et al. (2014). Moran and Queralto (2018) use identified VARs to estimate the impact of R&D on TFP.

We prefer a frequentist estimation strategy here since our reading of the empirical literature does not suggest an appropriate prior for parameters governing the R&D subsidy impact in our UK model. The approach taken here also allows us to evaluate the model’s performance together with the estimated parameter, using the Indirect Inference test. Formal econometric evaluation of DSGE models is now receiving increasing attention in the literature; see Giacomini (2013).

Before presenting the UK model in the next section, we highlight some of our modelling choices in the context of the DSGE literature discussed here — one notable difference being that we abstract from knowledge spillovers in the growth process. Growth occurs in this model due to the representative agent’s decision to spend time ‘innovating’; the resulting innovation is excludably donated to the firm, of which the agent is sole shareholder.<sup>9</sup> The assumption simplifies the model considerably while allowing the important testable policy implication to emerge, that R&D subsidies stimulate productivity growth by offsetting frictional barriers to R&D which tend to raise its costs. Thus we simply assume the existence of a distortion in the R&D margin which subsidies can eliminate; for instance, the fact that R&D tends to be risky which increases the cost of raising capital. The broader DSGE literature accommodates increasing theoretical complexity which is insightful; our aim is to strip back this complexity for the time being and see whether we find robust empirical evidence for a simple DSGE model in which R&D subsidies cause TFP behaviour. This is a nontrivial question, since there is a strong possibility that the causation works in the opposite direction, or that the effect is simply negligible and that an exogenous growth model is more appropriate. If support is found for the simple mechanism we propose here, we can proceed to model the microfoundations with more complexity.<sup>10</sup>

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<sup>9</sup>While the firm makes zero profits, the agent obtains the full benefit of productivity increases through resulting real wage increases.

<sup>10</sup>If, however, we start with a very specific model of the R&D process, it could be rejected if any details are wrong.



### 3. MODEL

We adapt the open economy Real Business Cycle model in Meenagh et al. (2010), adding an endogenous growth process based on Meenagh et al. (2007).<sup>11</sup> It is a two-country model with a single industry; one broad type of consumption good is traded internationally, but home goods sector production is differentiated from the foreign product. Consumers demand both home goods and imported goods. The home country is calibrated to the UK economy and the foreign country represents the rest of the world; its size therefore allows us to treat foreign prices and consumption demand as exogenous. International markets are cleared by the real exchange rate.

The model is a standard UK workhorse in terms of expected macroeconomic and open economy reactions. It is used as a testing vehicle to examine whether the productivity path is systematically affected by shocks to R&D subsidies in the UK — a relationship derived below from the model’s microfoundations. This model has the added practical advantage for the UK of capturing real exchange rate movements while abstracting from monetary policy, which underwent several regime changes in the UK during this period.<sup>12</sup> To give power to our empirical test, we must use a long sample spanning 1981-2010, but for this period we would have trouble specifying a single monetary policy rule without including structural breaks. This is one practical reason to exclude nominal frictions.<sup>13</sup> Moreover, R&D works on the supply side of the economy and in the medium and long run these effects should not be much if at all dependent on nominal rigidities (see e.g. the effects of R&D policy in Varga and t’Veld, 2011, Figure 1, p.658-59). This lends theoretical support to our decision to use an RBC model for this exercise.<sup>14</sup> Since this UK model has performed well in similar tests (Meenagh et al., 2010), the introduction of the R&D policy variable should test whether this policy hypothesis alone has caused the rejection.

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<sup>11</sup>The UK is a highly open economy and we judge that openness to be an important feature in an empirical analysis such as this.

<sup>12</sup>Policy went from money supply-targeting, to semi-officially shadowing the Deutsche Mark, joining and leaving the European Exchange Rate Mechanism, and finally to inflation-targeting with Central Bank independence.

<sup>13</sup>Others e.g. Varga and t’Veld (2011) in QUEST III use a short sample, 2000-2006, enabling them to include monetary policy rules of that period; but they do not wish to test the model for which they would need a much longer sample, encountering the same issues as we do.

<sup>14</sup>In the model we explicitly include dynamics due to real rigidities like adjustment costs, but simply include any omitted effects of nominal rigidities in the residual terms implied by the data.

### 3.1. Consumer Problem

The consumer chooses consumption ( $C_t$ ) and leisure ( $x_t$ ) to maximise lifetime utility,  $U$ :

$$U = \max E_0 \left[ \sum_{t=0}^{\infty} \beta^t u(C_t, x_t) \right] \quad (1)$$

$u(\cdot)$  takes the form:

$$u(C_t, x_t) = \theta_0 \frac{1}{(1 - \rho_1)} \gamma_t C_t^{(1 - \rho_1)} + (1 - \theta_0) \frac{1}{(1 - \rho_2)} \xi_t x_t^{(1 - \rho_2)} \quad (2)$$

$\rho_1, \rho_2 > 0$  are coefficients of relative risk aversion;  $\gamma_t$  and  $\xi_t$  are preference shocks, and  $0 < \theta_0 < 1$  is consumption preference.

The agent divides time among three activities: leisure, labour  $N_t$  supplied to the firm for the real wage  $w_t$ , and an activity  $z_t$  that is unpaid at  $t$  but known to have important future returns. The time endowment is:

$$N_t + x_t + z_t = 1 \quad (3)$$

Here the consumer chooses leisure, consumption, domestic and foreign bonds ( $b, b^f$ ) and bonds issued by the firm to finance its capital investment ( $\tilde{b}$ ), and new shares ( $S^p$ ) purchased at price  $q$ , subject to the real terms budget constraint.<sup>15</sup>

$$C_t + b_{t+1} + Q_t b_{t+1}^f + q_t S_t^p + \tilde{b}_{t+1} = w_t N_t - T_t + b_t(1 + r_{t-1}) + Q_t b_t^f(1 + r_{t-1}^f) + (q_t + d_t) S_{t-1}^p + (1 + \hat{r}_{t-1}) \tilde{b}_t \quad (4)$$

The taxbill  $T_t$  is defined further below. The only taxed choice variable in the model is  $z_t$ ; all other taxes are treated as lump sum to rule out wealth effects. Since the choice of  $z_t$  is left aside until Section 3.4 on endogenous growth, the taxbill is not relevant at this stage of the problem.  $Q_t = \frac{P_t^f}{P_t} \hat{E}_t$  gives relative consumer prices. The nominal exchange rate  $\hat{E}_t$  is assumed fixed;  $Q_t$  is then the relative import price.<sup>16</sup> Higher  $Q_t$  implies a real depreciation of domestic goods on world markets and hence an increase in competitiveness; this can be thought of as a real exchange rate depreciation.

The consumer's first order conditions yield the Euler equation (5), the intratemporal con-

<sup>15</sup>Price  $P_t$  of the consumption bundle is numeraire

<sup>16</sup> $b_{t+1}^f$  is a real bond - it costs what a unit of the foreign consumption basket ( $C_t^*$ ) would cost, i.e.  $P_t^*$  (the foreign CPI). In domestic currency, this is  $P_t^* \hat{E}_t$ . Assuming  $P_t^* \simeq P_t^f$  (i.e. exported goods from the home country have little impact on the larger foreign country) the unit cost of  $b_{t+1}^f$  is  $Q_t$ .

dition (6),<sup>17</sup> real uncovered interest parity (7), and the share price formula (8). First order conditions on  $\tilde{b}_{t+1}$  and  $b_{t+1}$  combine for  $\hat{r}_t = r_t$ . Indeed, returns on all assets ( $S_t^p$ ,  $b_{t+1}$ ,  $\tilde{b}_{t+1}$  and  $b_{t+1}^f$ ) are equated.

$$\frac{1}{(1+r_t)}\gamma_t C_t^{-\rho_1} = \beta E_t[\gamma_{t+1} C_{t+1}^{-\rho_1}] \quad (5)$$

$$\frac{U_x}{U_c}|_{U=0} = \frac{(1-\theta_0)\xi_t x_t^{-\rho_2}}{\theta_0 \gamma_t C_t^{-\rho_1}} = w_t \quad (6)$$

$$(1+r_t) = E_t \frac{Q_{t+1}}{Q_t} (1+r_t^f) \quad (7)$$

$$q_t = \frac{q_{t+1} + d_{t+1}}{(1+r_t)} = \sum_{i=1}^{\infty} \frac{d_{t+i}}{\prod_{j=0}^{i-1} (1+r_{t+j})} \quad (8)$$

Equation 8 rests on the further assumption that  $q_t$  does not grow faster than the interest rate,  $\lim_{i \rightarrow \infty} \frac{q_{t+i}}{\prod_{j=0}^{i-1} (1+r_{t+j})} = 0$ .

The domestic country has a perfectly competitive final goods sector, producing a version of the final good differentiated from the product of the (symmetric) foreign industry. The model features a multi-level utility structure (cf. Feenstra et al. 2014). The level of  $C_t$  chosen above must satisfy the expenditure constraint,

$$C_t = p_t^d C_t^d + Q_t C_t^f \quad (9)$$

$p_t^d \equiv \frac{P_t^d}{P_t}$ .  $C_t^d$  and  $C_t^f$  are chosen to maximise  $\tilde{C}_t$  via the following utility function (equation 10), subject to the constraint that  $\tilde{C}_t \leq C_t$ .

$$\tilde{C}_t = [\omega(C_t^d)^{-\rho} + (1-\omega)\varsigma_t(C_t^f)^{-\rho}]^{-\frac{1}{\rho}} \quad (10)$$

At a maximum the constraint binds;  $0 < \omega < 1$  denotes domestic preference bias. Import demand is subject to a shock,  $\varsigma_t$ . The elasticity of substitution between domestic and foreign varieties is constant at  $\sigma = \frac{1}{1+\rho}$ . First order conditions imply the relative demands for the imported and domestic goods:

$$\frac{C_t^f}{C_t} = \left( \frac{(1-\omega)\varsigma_t}{Q_t} \right)^{\sigma} \quad (11)$$

$$\frac{C_t^d}{C_t} = \left( \frac{\omega}{p_t^d} \right)^{\sigma} \quad (12)$$

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<sup>17</sup>Later we show that the return on labour time,  $w_t$ , is equal at the margin to the return on  $z_t$ .

Given equation 11 above, the symmetric equation for foreign demand for domestic goods (exports) relative to general foreign consumption is

$$(C_t^d)^* = C_t^* \left( (1 - \omega^F) \varsigma_t^* \right)^{\sigma^F} (Q_t^*)^{-\sigma^F} \quad (13)$$

\* signifies a foreign variable;  $\omega^F$  and  $\sigma^F$  are foreign equivalents to  $\omega$  and  $\sigma$ .  $Q_t^*$  is the foreign equivalent of  $Q_t$ , import prices relative to the CPI, and  $\ln Q_t^* \simeq \ln p_t^d - \ln Q_t$ .<sup>18</sup> An expression for  $p_t^d$  as a function of  $Q_t$  follows from the maximised equation 10:

$$1 = \omega^\sigma (p_t^d)^{\rho\sigma} + [(1 - \omega)\varsigma_t]^\sigma Q_t^{\rho\sigma} \quad (14)$$

A first order Taylor expansion around a point where  $p^d \simeq Q \simeq \varsigma \simeq 1$ , with  $\sigma = 1$ , yields a loglinear approximation for this:

$$\ln p_t^d = \hat{k} - \frac{1 - \omega}{\omega} \frac{1}{\rho} \ln \varsigma_t - \frac{1 - \omega}{\omega} \ln Q_t \quad (15)$$

The export demand equation is then

$$\ln(C_t^d)^* = \check{c} + \ln C_t^* + \sigma^F \frac{1}{\omega} \ln Q_t + \varepsilon_{ex,t} \quad (16)$$

where  $\check{c}$  collects constants and  $\varepsilon_{ex,t} = \sigma^F [\ln \varsigma_t^* + \frac{1 - \omega}{\omega} \frac{1}{\rho} \ln \varsigma_t]$ .

Assuming no capital controls, the real balance of payments constraint is satisfied.

$$\Delta b_{t+1}^f = r_t^f b_t^f + \frac{p_t^d E X_t}{Q_t} - I M_t \quad (17)$$

### 3.2. Firm Problem

The representative firm produces the final good via a Cobb Douglas function with constant returns to scale, where  $A_t$  is total factor productivity:

$$Y_t = A_t K_t^{1-\alpha} N_t^\alpha \quad (18)$$

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<sup>18</sup>  $Q_t^* = \frac{P_t^d}{P_t^*}$  - since  $Q_t = \frac{P_t^f}{P_t}$  and  $P_t$  is numeraire,  $Q_t = P_t^f$ . If domestic export prices hardly influence the foreign CPI then  $P_t^* \simeq P_t^f$ .

There are diminishing marginal returns to labour and capital. The firm also faces convex adjustment costs to capital. The firm undertakes investment, purchasing new capital via debt issue ( $\tilde{b}_{t+1}$ ) at  $t$ ; the cost  $\hat{r}_t$  is payable at  $t+1$ . Bonds are issued one for one with capital units demanded:  $\tilde{b}_{t+1} = K_t$ . The cost of capital covers the return demanded by debt-holders, capital depreciation  $\delta$  and adjustment costs,  $\tilde{a}_t$ .<sup>19</sup> The profit function is:

$$\pi_t = Y_t - \tilde{b}_{t+1}(\hat{r}_t + \delta + \kappa_t + \tilde{a}_t) - (\tilde{w}_t + \chi_t)N_t$$

$\tilde{w}_t$  is the real unit cost of labour;  $\kappa_t$  and  $\chi_t$  are cost shocks capturing random movements in marginal tax rates. The consumer's first order conditions showed  $\hat{r}_t = r_t$ . Substituting for  $\tilde{b}_{t+1} = K_t$  and  $\hat{r}_t = r_t$ , profits are:

$$\pi_t = Y_t - K_t(r_t + \delta + \kappa_t) - \frac{1}{2}\zeta(\Delta K_t)^2 - (\tilde{w}_t + \chi_t)N_t \quad (19)$$

Here adjustment costs are explicit, having substituted  $\tilde{b}_{t+1}\tilde{a}_t = K_t\tilde{a}_t = \frac{1}{2}\zeta(\Delta K_t)^2$ . Parameter  $\zeta$  is constant.

The firm chooses  $K_t$  and  $N_t$  to maximise expected profits, taking  $r_t$  and  $\tilde{w}_t$  as given. Assume free entry and a large number of firms operating under perfect competition. The optimality condition for  $K_t$  equates the marginal product of capital (net of adjustment costs and depreciation) to its price, plus cost shock –  $d$  is the firm's discount factor. Rearranged, this gives a non-linear difference equation in capital.

$$K_t = \frac{1}{1+d}K_{t-1} + \frac{d}{1+d}E_t K_{t+1} + \frac{(1-\alpha)}{\zeta(1+d)} \frac{Y_t}{K_t} - \frac{1}{\zeta(1+d)}(r_t + \delta) - \frac{1}{\zeta(1+d)}\kappa_t \quad (20)$$

Given capital demand, the firm's investment,  $I_t$ , follows via the capital accumulation identity.

$$K_t = I_t + (1 - \delta)K_{t-1} \quad (21)$$

The optimal labour choice gives the firm's labour demand condition:

$$N_t = \alpha \cdot \frac{Y_t}{\tilde{w}_t + \chi_t} \quad (22)$$

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<sup>19</sup>the adjustment cost attached to  $\tilde{b}_{t+1}$  is:  $\tilde{b}_{t+1}\tilde{a}_t = \tilde{b}_{t+1} \cdot \frac{1}{2}\zeta \left( \tilde{b}_{t+1} + \frac{\tilde{b}_t^2}{\tilde{b}_{t+1}} - 2\tilde{b}_t \right) = \frac{1}{2}\zeta(\Delta \tilde{b}_{t+1})^2$

Internationally differentiated goods introduce a wedge between the consumer real wage,  $w_t$ , and the real labour cost for the firm,  $\tilde{w}_t$ .<sup>20</sup> The wedge is

$$p_t^d = \frac{w_t}{\tilde{w}_t} \quad (23)$$

implying, via 15, the following relationship:

$$\ln w_t = \hat{k} + \ln \tilde{w}_t - \frac{1-\omega}{\omega} \ln Q_t - \frac{1-\omega}{\omega} \frac{1}{\rho} \ln \varsigma_t \quad (24)$$

### 3.3. Government

The government spends on the consumption good ( $G_t$ ) subject to its budget constraint.

$$G_t + b_t(1 + r_{t-1}) = T_t + b_{t+1} \quad (25)$$

Spending is assumed to be non-productive (transfers). As well as raising tax revenues  $T_t$  the government issues one-period bonds. Each period, revenues cover spending and the current interest bill:  $T_t = G_t + r_{t-1}b_t$  and so  $b_t = b_{t+1}$ . Therefore government debt is fixed in the model. Revenue  $T_t$  is made up as follows.

$$T_t = \Phi_t - s_t z_t \quad (26)$$

$s_t$  is a proportional subsidy rate on time spent in activity  $z_t$ .  $\Phi_t$ , a lumpsum tax capturing the revenue effects of all other tax instruments, responds to changes in  $s_t z_t$  to keep tax revenue neutral in the government budget constraint. Government spending is modeled as an exogenous trend stationary AR(1) process.

$$\ln G_t = g_o + g_1 t + \rho_g \ln G_{t-1} + \eta_{g,t} \quad (27)$$

where  $|\rho_g| < 1$  and  $\eta_{g,t}$  is a white noise innovation.

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<sup>20</sup>The firm's real cost of labour is the nominal wage  $W_t$  relative to domestic good price,  $P_t^d$ , while the real consumer wage is  $W_t$  relative to the general price  $P_t$ .

### 3.4. Productivity Growth

Assume that productivity growth is a linear function of time spent in some innovation-enhancing activity  $z_t$ .

$$\frac{A_{t+1}}{A_t} = a_0 + a_1 z_t + u_t \quad (28)$$

where  $a_1 > 0$ .  $z_t$  is the systematic channel through which policy incentives,  $s_t$ , drive growth.<sup>21</sup> Here  $z_t$  is assumed to be time spent in R&D.

The model is similar to Lucas (1990) where growth depends on time spent accumulating human capital. In the short term the return to labour (for a given level of human capital) is foregone to raise the human capital stock. The endogenous growth process below is adapted from Meenagh et al. (2007) to a decentralised framework.

Although in equation (28) TFP is a linear function of  $z_t$ , in practice we model  $z_t$  as a stationary mean zero variable. If  $z_t$  was non-stationary then a shock to it would be permanent and would raise the balanced growth rate. This would produce endogenous growth but is inconsistent with the data: resources devoted to R&D have increased dramatically over the long term, while long run output growth has been broadly stable (cf. Jones, 1995). In other words, equation 28 would imply that TFP is I(2), which is not supported. The model we set up therefore features a mechanism whereby temporary shocks to R&D around an exogenous trend generate permanent changes in the level of TFP and output, but cannot ultimately affect the long run growth rate of the model. It thus generates similar behaviour to models of semi-endogenous growth in response to R&D policy.<sup>22, 23</sup>

The consumer chooses  $z_t$  to maximise utility (eqn.s 1 and 2), subject to equations 3, 4 and 26. We assume the consumer's shareholdings are equivalent to a single share:<sup>24</sup>  $S_t^p = \bar{S} = 1$ . The rational agent expects  $z_t$  to raise her consumption possibilities through her role as the firm's sole shareholder. She knows that, given equation 28, a marginal change in  $z_t$  permanently raises productivity from  $t + 1$ . This higher productivity is fully excludable and donated to the atomistic firm she owns; higher productivity is anticipated to raise household income via firm

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<sup>21</sup>All other factors that systematically affect growth are therefore in the error term.

<sup>22</sup>In e.g. Jones (1995) and Segerstrom (1998) this is because the marginal idea product of R&D diminishes as the level of R&D increases, due to 'fishing out' or increasing complexity. A permanent subsidy increase then results in a permanent increase in R&D, but with level rather than growth effects on long run output per worker.

<sup>23</sup> $z_t$  is not in the model in practice when it is solved but, conceptually, any deterministic trend has been removed. Likewise, a deterministic trend is removed from  $s_t'$  and all other exogenous variables before solving the model. See Sections 3.6 and 4.7.1

<sup>24</sup>This allows the substitution in the budget constraint that  $q_t S_t^p - (q_t + d_t) S_{t-1}^p = -d_t$ .

profits paid out as dividends,  $d_t$  (everything leftover from revenue after labour and capital costs are paid). The choice is thought not to affect economy-wide aggregates; all prices are taken as parametric (note that the productivity increase is not expected to increase the consumer real wage here, though it does so in general equilibrium - cf. Boldrin and Levine, 2008).<sup>25</sup>

Substituting into the first order condition for  $z_t$  using equation 28 and rearranging for  $\frac{A_{t+1}}{A_t}$  yields (after some approximation)

$$\frac{A_{t+1}}{A_t} = a_1 \cdot \frac{\frac{\beta \rho_\gamma}{1-\beta \rho_\gamma} \cdot \frac{Y_t}{C_t}}{\frac{w_t}{C_t} (1-s'_t)} \quad (29)$$

The full derivation is given in the Appendix. We focus on  $\frac{s_t}{w_t} \equiv s'_t$ , a unit free measure with the dimensions of a rate unlike  $s_t$  which, like the wage, is an amount payable per unit of time. A first order Taylor expansion of the righthand side of equation 29 around  $s'_t = s'$  gives a linear relationship between  $\frac{A_{t+1}}{A_t}$  and  $s'_t$  of the form

$$d \ln A_{t+1} = b_0 + b_1 s'_t + \varepsilon_{A,t} \quad (30)$$

where  $b_1 = a_1 \cdot \frac{\frac{\beta \rho_\gamma}{1-\beta \rho_\gamma} \cdot \frac{Y}{C}}{\frac{w}{C} (1-s')^2}$ .<sup>26</sup> Note that this relationship came out of the first order condition for  $z_t$ . The household chooses  $z_t$  taking all other sources of productivity growth as exogenous. Equation 30 drives the behaviour of the model in simulations.

There are notable aspects of the R&D growth channel that we abstract from here. We do not include distance to the global technological frontier (cf. Grossman and Helpman, 1991); nor do we explicitly include spillovers in the micro-foundations (e.g. *inter alia* Jones, 1995). Many more theoretically rich models exist for how R&D subsidies can affect productivity, and there is no suggestion that growth is in reality as simple as this model suggests. The decision we have made is to write down a straightforward and more general model which implies the reduced form process in equation 30; we view this model as representative of a class of theoretical models which have this implication. We then look at whether the approximations made here are empirically justifiable.

The growth channel, activity  $z_t$ , is identified in empirical work by the choice of data for the policy variable  $s'_t$ ;  $z_t$  itself does not feature in the model listing (Appendix B). The policy

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<sup>25</sup>Given the time endowment  $1 = N_t + x_t + z_t$ , the agent has indifference relations between  $z_t$  and  $x_t$ , between  $x_t$  and  $N_t$ , and  $z_t$  and  $N_t$ . The intratemporal condition in 6 gives the margin between  $x_t$  and  $N_t$ ; here we focus on the decision margin between  $z_t$  and  $N_t$ , so the margin between  $z_t$  and  $x_t$  is implied. Therefore the substitution  $N_t = 1 - x_t - z_t$  can be made in the budget constraint.

<sup>26</sup>Other terms in the expansion are treated as part of the error term.



variable is proxied by the rate of direct subsidies to private sector R&D; see Section 4.2.2. The most obvious way such a subsidy could drive growth would be by stimulating R&D activity, but this identification strategy does not rule out other models with the same implication for the effect of R&D subsidies on productivity growth (even if that might be because R&D subsidies simultaneously increase worker human capital through strategic complementarities as in Redding, 1996). While in practice  $z_t$  could comprise other mechanisms besides simple R&D activity, our focus is on testing the relationship in equation 30 from subsidies to TFP.<sup>27</sup>

Substituting into 29 using 28 reveals a relationship between  $z_t$  and  $s'_t$ . Define  $\frac{\partial z_t}{\partial s'_t} \equiv c_1$ , assumed constant. This parameter enters the simulation explicitly in the producer labour cost equation:

$$\ln \tilde{w}_t = \text{const}_4 + \rho_2 \ln N_t + \rho_1 \ln C_t + \left[ \frac{1-\omega}{\omega} \right]^\sigma \ln Q_t + \rho_2 2c_1 s'_t + e_{w,t} \quad (31)$$

where  $e_{w,t} = -\ln \gamma_t + \ln \xi_t + \frac{1}{\rho} \left[ \frac{1-\omega}{\omega} \right]^\sigma \ln \varsigma_t$  — so the unit labour cost shock is a combination of preference shocks to consumption and leisure and to import demand. This equation is derived from the intratemporal condition (equation 6) which governs labour supply choices (full derivation in Appendix). Since  $s'_t$  is an incentive to R&D,  $c_1 > 0$  and hence  $\frac{d \ln \tilde{w}_t}{ds'_t} > 0$  and equally  $\frac{d \ln N_t}{ds'_t} < 0$ , as equation 31 is simply the labour supply condition rearranged. The worker's response to a higher subsidy rate on  $z_t$  is to reduce time spent in ordinary employment.

### 3.5. Closing the model

Goods market clearing in volume terms is:

$$Y_t = C_t + I_t + G_t + EX_t - IM_t \quad (32)$$

All asset markets also clear.

A transversality condition is also required to ensure a balanced growth equilibrium is reached for this open economy, to rule out growth financed by insolvent borrowing rather than growing fundamentals. The restriction on the balance of payments is that the long run

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<sup>27</sup>If the model were specified in non-stochastic form, government intervention would not be justified as there are no explicit distortions leading to suboptimal R&D; the subsidy itself could then generate a suboptimal welfare outcome. However, the model's residuals include temporary and permanent welfare distortions, along with nominal rigidities, the effects of other tax instruments etc. See Brinca (2014) for the interpretation of model residuals as efficiency wedges (also Sustek, 2011). Given the presence of distortions to R&D incentives in the residuals, subsidies can be a second best policy. However, we intend this as a positive exercise into the TFP effects of subsidies and do not emphasise the welfare properties of the model.

change in net foreign assets (the capital account) is zero. At a notional date  $T$  when the real exchange rate is constant, the cost of servicing the current debt is met by an equivalent trade surplus.

$$r_T^f b_T^f = - \left( \frac{p_T^d \cdot EX_T}{Q_T} - IM_T \right) \quad (33)$$

The numerical solution path is forced to be consistent with the constraints this condition places on the rational expectations. In practice it constrains household borrowing since government solvency is ensured already, and firms do not borrow from abroad. When solving the model, the balance of payments constraint is scaled by output so that the terminal condition imposes that the ratio of debt to gdp must be constant in the long run,  $\Delta \hat{b}_{t+1}^f = 0$  as  $t \rightarrow \infty$ , where  $\hat{b}_{t+1}^f = \frac{b_{t+1}^f}{Y_{t+1}}$ . The model is loglinearised before solution and simulation; the full model listing is in Appendix B.

### 3.6. Exogenous variables

Stationary exogenous variables are shocks to real interest rates (Euler equation), labour demand, real wages, capital demand, export demand and import demand. These are not directly observed but are implied as the difference between the data and the model predictions. Those differences  $e_{i,t}$  are treated as trend stationary AR(1) processes:

$$e_{i,t} = a_i + b_i t + \rho_i e_{i,t-1} + \eta_{i,t} \quad (34)$$

$\eta_{i,t}$  is an i.i.d mean zero innovation term;  $i$  identifies the shock. We model foreign consumption demand, government consumption, foreign interest rates and policy variable  $s_t'$  similarly. AR(1) coefficients  $\rho_i$  are estimated. Where expectations enter, they are estimated using a robust instrumental variable technique (Wickens, 1982; McCallum, 1976); they are the one step ahead predictions from an estimated VECM. Where  $a_i \neq 0$  and  $b_i \neq 0$ , detrended residual  $\hat{e}_i$  is used:

$$\hat{e}_{i,t} = \rho_i \hat{e}_{i,t-1} + \eta_{i,t} \quad (35)$$

$$\hat{e}_{i,t} = e_{i,t} - \hat{a}_i - \hat{b}_i t \quad (36)$$

The innovations  $\eta_{i,t}$  are approximated by the fitted residuals from estimation of equation 35,  $\hat{\eta}_{i,t}$ . The Solow residual  $\ln A_t$  is modelled as a unit root process with drift driven by a

stationary AR(1) shock and by exogenous variable  $s'_t$ , following equation 30.

$$\ln A_t = d + \ln A_{t-1} + b_1 s'_{t-1} + e_{A,t} \quad (37)$$

$$e_{A,t} = \rho_A e_{A,t-1} + \eta_{A,t} \quad (38)$$

Deterministic trends are removed from exogenous variables since they enter the model's balanced growth path. We focus here on how the economy deviates from steady state in response to shocks — in particular, stationary shocks to R&D subsidies. Such shocks will have a permanent shift effect on the path of TFP via its unit root. Due to their persistence they also generate transitional TFP growth episodes above long-run trend. As mentioned in Section 3.4, this is how we achieve consistency with the data given our linear specification in equations (28) and (30).

## 4. EMPIRICAL WORK

### 4.1. Indirect Inference Methods

The model in the preceding section is tested and estimated using the Indirect Inference method from Le et al. (2011). The approach is similar to traditional RBC moment-matching, but adds a formal test for the closeness of moments. Samples generated from the bootstrapped model and the observed data are described atheoretically by an auxiliary model, used as a basis for the comparison. The full methodology is given in Le et al. (2016). We describe it briefly here.

Given parameter set  $\theta$ ,  $J$  bootstrap simulations are generated from the DSGE model. Having added back the effects of deterministic trends removed from shocks, an auxiliary model is estimated for all  $J$  pseudo-samples. The estimated auxiliary model coefficient vectors  $a_j$  ( $j = 1, \dots, J$ ) yield the variance-covariance matrix  $\Omega$  of the DSGE model's implied distribution for these coefficients. Hence the small-sample distribution for the Wald statistic  $WS(\theta)$  is obtained:

$$WS(\theta) = (a_j - \overline{a_j(\theta)})' W(\theta) (a_j - \overline{a_j(\theta)}) \quad (39)$$

$\overline{a_j(\theta)}$  is the mean of the  $J$  estimated vectors and  $W(\theta) = \Omega(\theta)^{-1}$  is the inverse of the estimated variance-covariance matrix. The test statistic,  $WS^*(\theta)$ , is  $WS^*(\theta) = (\hat{\alpha} - \overline{a_j(\theta)})' W(\theta) (\hat{\alpha} - \overline{a_j(\theta)})$  — this depends on the distance between  $\overline{a_j(\theta)}$  and  $\hat{\alpha}$ , where  $\hat{\alpha}$  is the coefficient vector

estimated from the UK data. Inference proceeds by comparing the percentile of the Wald distribution in which the test statistic falls with the chosen size of the test; for 5% significance, a percentile above 95% signifies rejection. We can present the same information as a Mahalanobis distance or as a p-value.

For estimation, a ‘simulated annealing’ algorithm performs the indirect inference Wald test for points inside a bounded parameter space. We search for a structural parameter set such that the restrictions the model imposes, including the causal relationship from R&D subsidies to TFP, do not lead it to be rejected as a data generating process. This is discussed further below.

## 4.2. Data

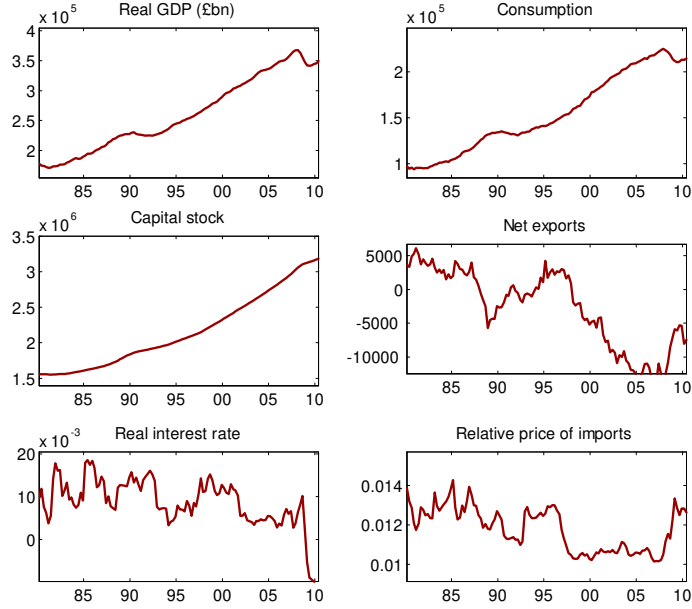
### 4.2.1. UK Macroeconomic Data

We use unfiltered data from 1981 to 2010. For problems inherent in data filtering see e.g. Hamilton (2016). Here we are interested in relatively long growth episodes in response to shocks propagated through non-stationary TFP; the risk of mistaking that response for a change in underlying trend and removing it is high with the HP filter (cf. Comin and Gertler, 2006). The auxiliary model is therefore a Vector Error Correction Model since the data is non-stationary; this is discussed further in section 4.3. Key UK macroeconomic data is plotted in Figure 1. Data sources are listed in Appendix C.

### 4.2.2. Data on R&D Subsidies

The hypothesis is that  $b_1 > 0$  in equation 30, i.e.  $s'_t$  encourages the growth driver  $z_t$ , defined here as R&D. Since  $z_t$  itself is not included in model simulations, the choice of data for  $s_t$  identifies the growth channel, as mentioned earlier. The policy variable used is the ratio of business-performed R&D expenditure (BERD) financed directly by government, to the total level of BERD (all sources of funding). We choose this proxy because  $s'_t$  represents a unit-free subsidy rate, which should be the amount given in subsidies as a percentage of the activity: therefore the denominator is the amount of private sector R&D while the numerator is the amount given in grants that make that activity cheaper.

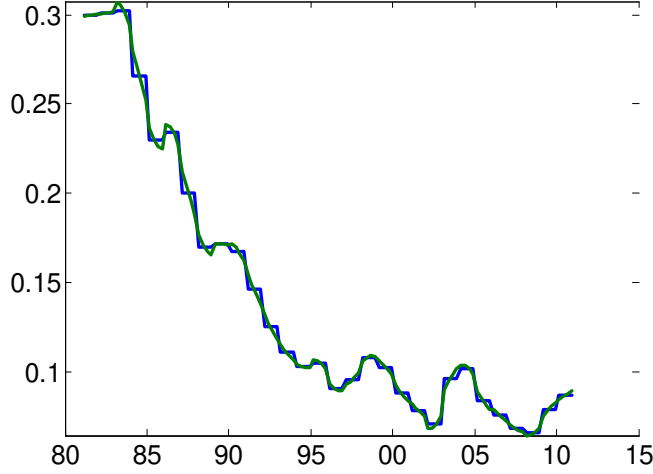
Aggregate data on BERD is available from 1981 and is annual with missing values at 1982 and 1984. Missing values are interpolated as the arithmetic average of the two contiguous values (robustness checks on the interpolation choice show it has no impact on results). The



**FIG. 1** Key quarterly UK data for 1980-2010.

ratio is interpolated from annual to a quarterly frequency using a constant average match interpolation. Figure 2 plots the series for constant average and quadratic average interpolation. The detrended subsidy variable is modeled as a persistent but stationary AR(1) process (see exogenous variables section above).

This R&D subsidy variable excludes fiscal incentives to R&D which have increased in the UK since 2000, so it is only a partial proxy for policy incentives to R&D. However, fiscal incentives as measured by the OECD B-Index may affect R&D and productivity growth differently to direct subsidies (e.g. Foreman-Peck, 2013), so it is not immediately clear that we should combine them into a single index. Likewise, no indicator of intellectual property rights spans a long enough timeframe for this investigation; and for the UK such an indicator would show little time series variation. We could resort to patent counts to proxy innovation policy, but a) these are an outcome and may not be a good proxy for policy and b) they respond in a way that may have nothing to do with productivity (see e.g. van Pottelsberghe de la Potterie, 2011, for related literature). For these reasons, the subsidy variable employed here is preferred.



**FIG. 2** Business R&D Subsidy Variable. Ratio of Government Funded BERD to Total BERD. Constant and average match interpolation. Source, OECD

#### 4.3. Auxiliary Model

The full solution to the structural model can be represented as a cointegrated VECM rearranged as a VARX(1) – see Appendix D. The general form is

$$y_t = [I - K]y_{t-1} + K\Pi x_{t-1} + n + \phi t + q_t \quad (40)$$

The error  $q_t$  contains suppressed lagged difference regressors, while  $t$  captures the deterministic trend in  $\bar{x}_t$  (the balanced growth behaviour of the exogenous variables) affecting both the endogenous and exogenous variables.  $x_{t-1}$  contains unit root variables, present to control for the impact of past shocks on the long run path of both  $x$  and  $y$ . This VARX(1) approximation to the reduced form of the model is the unrestricted auxiliary model used to assess the closeness of model-simulated samples to the observed data.

The focus is on the transitional growth of output and TFP and whether our assumptions about the causal role of R&D policy are correct, so we use a ‘directed’ Wald (Le et al. 2011). Endogenous variables in the auxiliary VARX(1) are therefore output and TFP, while exogenous lagged variables are the subsidy variable and net foreign assets,  $b_{t-1}^f$ . The latter captures the stochastic trend in the model through its unit root.

The test is whether the model replicates the features not just of output and productivity

taken singly, but the joint behaviour of those variables conditional on the behaviour of any non-stationary predetermined variables and of the policy variable. Although this VARX(1) is a severe approximation of the model’s solution, the power of the test remains strong; the small sample properties of Indirect Inferences are discussed for a variety of models in Le et al. (2016). Since Monte Carlo studies can be model-dependent, we also investigate the power of the test in this particular context in Section 4.6 below.

The vector  $a_j$  used to construct the Wald distribution (eq. 39) includes OLS estimates of coefficients on the lagged endogenous and exogenous variables, as well as the variances of the fitted auxiliary model errors; the same coefficients make up vector  $\hat{\alpha}$  estimated on the observed data. The VARX errors are also tested for stationarity. The trend term in the VARX(1) captures the deterministic trend in the data and simulations. Since the focus of the study is on the stochastic trend resulting from the shocks, the deterministic trend is not part of the Wald test on which the model’s performance is evaluated.

#### 4.4. Indirect Inference Testing and Estimation Results

We estimate a number of the structural parameters of the model using Indirect Inference and report those estimates as well as the Wald test statistic for the model with that set of parameters. The structural parameters we estimate are listed in Table 3, Column 1. They are generally preference-related parameters, as well as the policy-growth parameter, for which no strong priors exist. Due to the attention paid in the literature to adjustment inertia in the response of R&D to policy determinants (Guellec and van Pottelsberghe, 2000; Westmore, 2013; Di Comite et al. 2015), we also test and estimate the model with a 4 quarter lag in the subsidy rate, whereas the baseline model assumes a 1 quarter lag. Some structural model coefficients are kept fixed throughout; see Table 1. Long-run ratios featuring in the loglinearised model for  $\frac{M}{Y}$ ,  $\frac{X}{Y}$ ,  $\frac{Y}{C}$  and  $\frac{G}{C}$  are calibrated to UK post-war averages.  $\frac{X}{C}$  and  $\frac{M}{C}$  are then set to be consistent with those values.

To initiate the Indirect Inference estimation process we must choose a starting set of structural parameters for the model. For most of the parameters, initial values are taken from Meenagh et al (2010), since we have used that model as our starting point. However, the model we investigate here features substantial modifications around the role of R&D subsidies, necessitating re-estimation of its structural parameters.<sup>28</sup> For the initial value of  $b_1$ , the

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<sup>28</sup>The addition of the R&D process to the model changes the dynamic properties of the model, so the initial calibration (based on a model without R&D, calibrated for a different sample) is unlikely to be correct. Indeed,

Labour share in output, $\alpha$	0.7
Quarterly discount factor, $\beta$	0.97
Quarterly capital depreciation rate, $\delta$	0.0125
$K/C$	0.196
$Y/C$	1.732
$M/C$	0.369
$X/C$	0.361
$G/C$	0.442
$X/Y$	0.208
$M/Y$	0.213
$Y/K$	0.333

TABLE 1  
Fixed structural parameters

impact of the subsidy shock on next period’s TFP (equation 30), the macroeconometric literature does not offer a strong prior in terms of sign or magnitude. Estimates for the impact of R&D on TFP and of direct subsidies on TFP or output growth vary across different regression models and estimators, for different samples and for different measures of R&D or of the policy environment. The same holds for  $c_1$ ; compare e.g. Falk (2006) to Westmore (2013). Lacking a compelling rationale for calibrating this model from the existing literature, starting values chosen for these are 0.1 and 0.06 respectively, and we search around these values in the estimation procedure.<sup>29</sup>

The initial parameter set is given in Appendix F, along with the implied AR(1) coefficients for stationary exogenous variables. Analysis of impulse response functions show real business cycle behaviour consistent with Meenagh et al. (2010); impulse responses for a one-off policy shock are likewise as expected. A preliminary to the estimation is to set bounds on the parameter space; these are set at 30% either side of the initial calibration. If a parameter’s starting value is inappropriate, the estimation process will move towards one of the initial bounds, indicating that the bound should be shifted.

When the model is estimated by Indirect Inference a structural parameter set is found such that the model is not rejected by the test. The estimates are shown in Table 3, with the implied AR(1) coefficients for the exogenous variables in Table 4. For the parameters listed in Table 3, column 3, the test statistic falls in the 77th percentile of the distribution, signifying a comfortable non-rejection. Several coefficients have moved some way from their starting

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when the Indirect Inference test is applied to the model with this calibration it is rejected.

<sup>29</sup>A small starting value for  $c_1$  is preferred since the labour supply effects induced by policy change should plausibly be small.



values. In terms of the key results of this study, the estimate for  $b_1$  is 0.0901. This is the short run impact of a temporary shock to the direct R&D subsidy rate on TFP growth. To see the longer run impact of a one-off shock to the subsidy rate necessitates impulse response analysis, which we present in Section 4.7. There we show that the estimated model presented and tested here implies that a one-off, temporary shock to the R&D subsidy rate of magnitude 0.01 stimulates an average increase in the per annum output growth rate of 0.0011 lasting over 17 years. This is a reasonably impressive effect for such a small shock. Such implications fit with the results of e.g. Varga and t’Veld (2011, Fig.1) using QUEST III.

Assuming a 4 quarter lag for the impact of the subsidy shock yields a borderline non-rejection with a Wald percentile of 94.48, obtained from a different structural parameter set (Table 3, col. 4). This is a much weaker result.

#### 4.5. Variance Decomposition

A variance decomposition for key variables with this coefficient set is reported in Table 2.<sup>30</sup> See Appendix E for the full variance decomposition (all endogenous variables); here we pick out output and TFP due to their relevance for the growth question, as well as labour supply (impacted by the subsidy) and key open economy variables: the real interest rate, real exchange rate and net foreign assets. The identified subsidy shock generates considerable variability across all endogenous variables and accounts for 62.9% of total variance in TFP in the estimated model, more than the independent shock to TFP.<sup>31</sup> The estimated value of  $b_1$  is clearly large enough to distinguish this model clearly from an exogenous productivity growth model.

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<sup>30</sup>We bootstrap the model and calculate the variance of the simulated endogenous variables generated by each of the eleven shocks, taken one at a time. For each column, the cell values indicate the proportion of the total model variance for that endogenous variable generated by each exogenous variable; columns of Table 2 sum to unity.

<sup>31</sup>The subsidy shock and shocks to  $e_{A,t}$  are bootstrapped independently.

	<b>r</b>	<b>Output</b>	<b>Labour</b>	<b>Q</b>	<b>NFA</b>	<b>TFP</b>
$e_r$	0.169	0.002	0.009	0.012	0.031	0.000
$e_A$	0.231	0.350	0.228	0.300	0.012	0.371
$e_N$	0.031	0.002	0.015	0.001	0.001	0.000
$e_K$	0.160	0.025	0.045	0.014	0.012	0.000
$e_w$	0.122	0.020	0.162	0.006	0.005	0.000
$e_X$	0.034	0.010	0.103	0.145	0.653	0.000
$e_M$	0.028	0.001	0.014	0.013	0.054	0.000
$e_{subs}$	0.142	0.589	0.406	0.470	0.096	0.629
$C^F$	0.005	0.002	0.016	0.036	0.131	0.000
$r^F$	0.071	0.000	0.001	0.004	0.004	0.000
$G$	0.005	0.000	0.002	0.000	0.000	0.000

TABLE 2

Variance decomposition for key endogenous variables based on estimated parameter set 1.  
NFA is Net Foreign Assets. Q is the real exchange rate.

		Estimates I	Estimates II (4-quarter lag)
CRRRA coefficient ( $C_t$ )	$\rho_1$	0.9712	0.7156
CRRRA coefficient ( $x_t$ )	$\rho_2$	1.5198	1.0674
Preference weight on $C_t$	$\theta_0$	0.5267	0.5657
Home bias in consumption	$\omega$	0.5431	0.7988
Foreign equivalent of $\omega$	$\omega^F$	0.8819	0.7344
Import demand elasticity	$\sigma$	0.7676	0.9380
Elasticity of substitution ( $C_t^{d*}, C_t^{f*}$ )	$\sigma^F$	0.8522	0.5009
Capital equation coefficients	$\zeta_1, \zeta_2, \zeta_3, \zeta_4$	0.63, 0.35, 0.02, 0.24	0.61, 0.37, 0.02, 0.20
$\frac{\partial R \& D_t}{\partial s'_t}$	$c_1$	0.0632	0.0480
$\frac{\partial [d \ln A_{t+1}]}{\partial s'_t}$	$b_1$	0.0901	0.0969
Wald percentile		77.04	94.48

TABLE 3  
Structural Model Parameters

Exogenous variable	AR coefficient	Estimated Model 1	Estimated Model 2
Shock to real interest rate	$\rho_r$	0.858	0.839
Shock to $TFP$	$\rho_A$	0.577	0.588
Shock to labour demand	$\rho_N$	0.897	0.913
Shock to capital demand	$\rho_K$	0.951	0.950
Shock to real wage	$\rho_{\tilde{w}}$	0.837	0.943
Shock to export demand	$\rho_X$	0.939	0.938
Shock to import demand	$\rho_M$	0.832	0.854
Shock to R&D subsidy	$\rho_S$	0.974	0.971
Shock to foreign consumption demand	$\rho_{CF}$	0.939	0.953
Shock to foreign real interest rate	$\rho_{rF}$	0.851	0.837
Shock to government consumption	$\rho_G$	0.972	0.951

TABLE 4  
AR coefficients for stationary exogenous variables

Extent of falseness (absolute), $\theta$	TRUE	0.50%	1.00%	1.50%	2.00%	2.50%	3.00%
Rejection rate	5%	5.80%	8.82%	26.58%	84.68%	100.0%	100.0%

TABLE 5  
Rejection rates, all coefficients falsified together

#### 4.6. Power Exercise

The small sample properties of Indirect Inference have been investigated elsewhere (see Le et al. 2016 for references). However, Monte Carlo results are difficult to generalise from one context to another so we check the power of the Indirect Inference test for our particular setup. To do this, we introduce falseness into the structural parameters,  $\theta$ , moving them away from predefined true values by a certain percentage (randomly in either a positive or negative direction). Using a bootstrapped Wald distribution based on the misspecified model, we see whether the Indirect Inference test as implemented above will correctly reject this model given a sample from the true (correctly specified) model. The rate at which the test statistic falls in the 95th-100th percentile range of the distribution, for a particular degree of falseness, gives a sense of how reliable the procedure is. Rejection rates are given in Table 5. The results of the exercise indicate that the testing method applied in the study is powerful. Coefficients just 2.5% away from their true values will result in a certain rejection.

The above power function holds when all parameters are falsified together to the same degree. We would most of all like to know whether the addition of the R&D subsidy is appropriate. This policy affects the model via parameters  $b_1$  and  $c_1$ . We therefore investigate the power of the test when these coefficients alone are misspecified, holding all other coefficients to their true values. The results are reported in Table 6. When just two coefficients are falsified the power of the test is reduced. However, the test rejects over 99% of the time when the coefficients  $b_1$  and  $c_1$  are 50% away from their true values. This furnishes us with a confidence interval for our estimates.

What we see here is that our estimates lie within defined and rather close accuracy bounds. The R&D parameter cannot lie outside the region (0.04, 0.14) or the model would have been rejected; we conclude that R&D does affect growth positively. More generally, we can be sure that the model's parameters must lie collectively within a range of 2.5% of their true values; that is to say, if they were all perturbed randomly more than this percentage, the model would be rejected.

<b>Falseness (%)</b>	<b>0</b>	<b>1</b>	<b>3</b>	<b>5</b>	<b>7</b>	<b>10</b>
Rejection rate (%)	5.0	5.34	5.98	7.22	8.88	12.84
<b>Falseness (%)</b>	<b>15</b>	<b>20</b>	<b>30</b>	<b>40</b>	<b>50</b>	<b>60</b>
Rejection rate (%)	23.62	40.72	75.94	94.22	99.18	99.88
<b>Falseness (%)</b>	<b>0</b>	<b>-1</b>	<b>-3</b>	<b>-5</b>	<b>-7</b>	<b>-10</b>
Rejection rate (%)	5.0	4.92	4.72	4.90	5.32	6.40
<b>Falseness (%)</b>	<b>-15</b>	<b>-20</b>	<b>-30</b>	<b>-40</b>	<b>-50</b>	<b>-60</b>
Rejection rate (%)	10.54	18.64	55.92	93.52	99.94	100.0

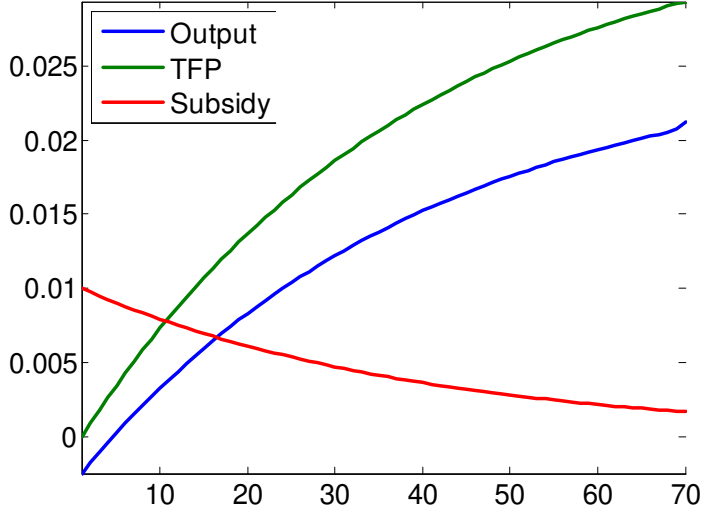
TABLE 6  
Rejection rates when just two structural coefficients are falsified

#### 4.7. Policy Reform and Growth Episode

A temporary shock to the detrended R&D subsidy has the effect in the model of increasing the level of TFP permanently and also generates a long-lasting TFP growth episode, with knock-on effects on the rest of the economy. We conduct impulse response analysis for a one-off, 1 percentage point shock to  $s'_t$ . More precisely, all exogenous innovations are set to zero for all  $t$  except for the innovation  $\eta_{s,t}$  in the subsidy shock process (see model listing, Appendix B). Given  $s'_t = \rho_s s'_{t-1} + \eta_{s,t}$  and  $\eta_{s,0} = 0.01$  with  $\eta_{s,t} = 0$  for  $t > 0$ , we track how this impulse is transmitted to the rest of the model through equation 30 and 31. As an exogenous innovation,  $\eta_{s,0} = 0.01$  is unexpected but its persistence is expected by rational agents who are assumed to know the structure of the model. The simulation is based on the estimated structural parameter set found above. Impulse responses are shown in Figure 3. After 70 quarters the loglevel of output is 2 percentage points higher than its no shock state (note, balanced growth has been removed here). The average annual growth increase over the 17.5 year episode is therefore 0.11 percentage points per annum.<sup>32</sup>

How confident can we be in these results? The power exercise above shows that the Indirect Inference test (exactly as applied in this paper) is robust against misspecification in the model's structural parameters. In our 'worst case scenario' in which only the R&D subsidy parameters are misspecified, we found that these estimates can deviate by up to 60%; that is,  $b_1$  lies in the interval (0.04, 0.14). We use this to construct the uncertainty interval for the average annual growth increase resulting from the temporary policy reform as (0.06, 0.17) percentage points per annum. Supposing some misspecification in all the estimates together, the uncertainty

<sup>32</sup>We also carry out a one-off permanent reform. As equation (30) would suggest, this changes the drift term in TFP, implying an increase in the balanced growth rate of the model and so a much larger impact. However, such a non-stationary specification for the subsidy variable would render TFP I(2) given our modelling assumptions and, though illustrative as a one-off policy experiment, is at odds with the data features we aim to match.

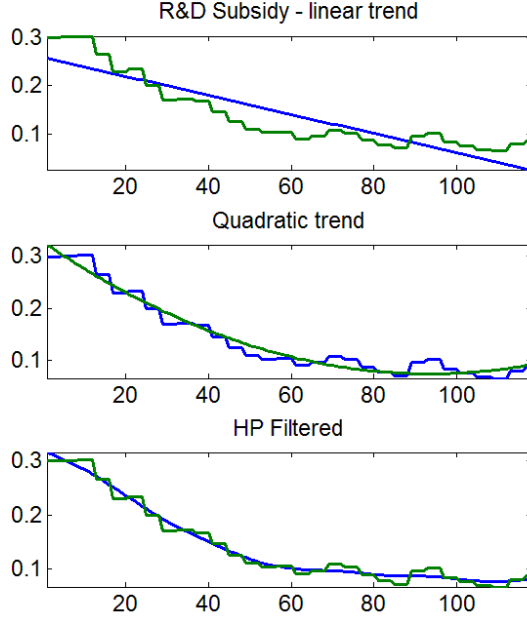


**FIG. 3** Impulse Responses for a 1 pc point increase in R&D subsidies; 70 quarters.

interval would be considerably smaller as the test would tolerate only 2.5% misspecification in the R&D subsidy coefficients.

There is the further issue of identification. Work checking the identification of rational expectations DSGE models finds that they generally are overidentified (the notable exception is models featuring sunspots); see Le et al. 2017. It is a priori likely that the model we use here is identified since models of this type routinely pass identification tests, but in particular we would like to show that the reduced form of this model could not be confused with a model in which R&D subsidies respond endogenously to TFP. To check identification we apply the numerical identification test developed by Le et al (2017).<sup>33</sup> For this test a 5 variable VARX(4) is used as the auxiliary model. We find that when the structural parameters are falsified by 0.3% together (randomly, up or down), false models are rejected 100% of the time. Therefore the VAR distribution implied by the true model is clearly distinguishable from that implied by other models, even those with parameters in the near neighbourhood of the ‘true’ set.

<sup>33</sup>The idea is to check whether any other structural model could generate the model’s reduced form by creating a large number of data samples of large size from the true model, and testing whether any possible alternative model is rejected for these samples at the same 5% rate as the true model itself.



**FIG. 4** R&D subsidy variable - various detrending methods

#### 4.7.1. Robustness checks

Robustness checks show that results are invariant to the interpolation technique (quadratic versus constant match) and to the way in which missing values were supplied for years 1982 and 1984.<sup>34</sup> We also check the detrending method for the R&D subsidy variable. Though direct subsidies have fallen steadily since the 1980s, from the late 1990s the trend slows. We therefore try removing the trend using i) the HP filter and ii) a quadratic time trend (Fig. 4). The earlier results are robust for the HP filtered series — the coefficient set reported in Table 3, column 4, is firmly not rejected with a test statistic in the 84th percentile of the Wald distribution. With the quadratic time trend the model is rejected at the 5% significance level.

## 5. CONCLUSION

We have written down a DSGE model particularly suited to the UK open economy in which productivity is driven systematically by direct subsidies to private sector R&D. Structural

<sup>34</sup>Missing values were calculated as i) the average of two contiguous values, ii) equal to previous value, iii) equal to following value. The Wald test result was similar for all three.

models of this kind are valuable tools for policymakers, but it is increasingly recognised that the value of their quantitative implications rests on the credibility of the structural parameters. Taking our cue from the incipient literature estimating and evaluating DSGE models, we estimate and test the model by Indirect Inference for the period 1981 – 2010. Our test focuses on whether the model can explain output and productivity as endogenous variables, and we find that it does. The estimated impact of current direct subsidies to private R&D on total factor productivity growth one-quarter ahead,  $b_1$ , is 0.09, signifying that in this sample a 1 percentage point increase in the detrended ratio of government funded BERD to total BERD raises productivity by 0.09 percent over the quarter, with permanent effects on the level. Given the estimated structural model, we conduct a simulated policy reform experiment. A one-off, one percentage point increase in direct subsidies dying out gradually generates a transitional growth episode in TFP lasting nearly two decades. This translates into an increase in the average annual growth rate of output of 0.2 percentage points over those decades. Our results thus strongly suggest that there is a role for R&D subsidies in promoting or maintaining growth in the medium term.

The power exercise we conduct lends significant robustness to these conclusions on the role of R&D subsidies. In our Monte Carlo study, the introduction of 2.5% misspecification in the structural parameters leads to a 100% rejection rate. When falseness is introduced *only* into the two coefficients particularly related to subsidies ( $b_1$ ,  $c_1$ ) the test is still sure to reject the model when these two parameters stray further than 50% from their true values. This allows us to construct uncertainty bounds around our estimates (and hence around the predicted growth episode): in the case of  $b_1$ , the ‘worst case’ interval is (0.04, 0.14).

We also apply the numerical model identification test proposed in Le et al. (2017), and confirm that the model is identified. This is a key strength of the approach, as there is no ambiguity in the causality running between policy shocks and economic growth. A model in which growth causes policy, for example, would be clearly distinguishable from the model we have tested here. Therefore this study adds empirical support for a causal impact of R&D policy on transitional growth in the UK since the 1980s.

Finally, the study fits within a wider research agenda on the role of R&D policy in economic growth in industrialised countries. The model abstracts heavily from the processes surrounding the R&D investment decision and the way that direct subsidies enter it in practice. A more elaborate model of the R&D channel could give greater insight into exactly how direct subsidies



drive TFP at the level of microfoundations. In this study we provide evidence of the positive direction of the subsidy impact and the extent of that effect on the macroeconomy, findings which are certainly of interest to policymakers and which seem to be of first order importance; future work can build on this.

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## APPENDIX A: MODEL DERIVATIONS, CONT.

### A.1. First order condition for $z$

The first order condition for  $z_t$  is:

$$\frac{dL}{dz_t} = 0 = -\beta^t \lambda_t w_t + \beta^t \lambda_t s_t + E_t \sum_{i=1}^{\infty} \beta^{t+i} \lambda_{t+i} \cdot \frac{d d_{t+i}}{dz_t}$$

At the  $(N_t, z_t)$  margin, the optimal choice of  $z_t$  trades off the impacts of a small increase  $dz_t$  on labour earnings, subsidy payments, and expected dividend income. Here,  $\frac{dA_{t+i}}{dA_{t+i-1}} = \frac{A_{t+i}}{A_{t+i-1}}$  and hence for  $i \geq 1$ ,  $\frac{d A_{t+i}}{dz_t} = \frac{d A_{t+i}}{d A_{t+i-1}} \cdot \frac{d A_{t+i-1}}{d A_{t+i-2}} \cdots \frac{d A_{t+2}}{d A_{t+1}} \cdot \frac{d A_{t+1}}{dz_t} = A_{t+i} \frac{A_t}{A_{t+1}} a_1$ . In turn,  $\frac{d d_{t+i}}{dz_t} = \frac{Y_{t+i}}{A_{t+i}} A_{t+i} \frac{A_t}{A_{t+1}} a_1$ . It may be objected that  $dz_t$  enhances output directly through its effect on productivity (holding inputs fixed), and also induces the firm to hire more capital to exploit its higher marginal product (similarly for labour). We assume the effect of  $dz_t$  on the future dividend ( $d_{t+i} = \pi_{t+i}$ ) is simply its direct effect via higher TFP, on the basis that any effects on input demands are second order. Therefore the expected change in the dividend stream is based on forecasts for choice variables (set on other first order conditions) that are assumed independent of the agent's own activities in context of price forecasts; she anticipates only the effect of  $z_t$  on the level of output that can be produced with given inputs from  $t+1$  onwards. With substitution from 28, the rearranged first order condition is:

$$\beta^t \gamma_t C_t^{-\rho_1} w_t = \frac{a_1}{a_0 + a_1 z_t + u_t} \cdot E_t \sum_{i=1}^{\infty} \beta^{t+i} \gamma_{t+i} C_{t+i}^{-\rho_1} Y_{t+i} + \beta^t \lambda_t s_t$$

On the left hand side is the return on the marginal unit of  $N_t$ , the real consumer wage; on the right is the present discounted value of the expected increase in the dividend stream as a result of a marginal increase in  $z_t$ , plus time  $t$  subsidy incentives attached to R&D activity.<sup>35</sup> Substituting again from 28 for  $z_t$  yields

$$\frac{A_{t+1}}{A_t} = a_1 \cdot \frac{E_t \sum_{i=1}^{\infty} \beta^i \gamma_{t+i} C_{t+i}^{-\rho_1} Y_{t+i}}{\gamma_t C_t^{-\rho_1} (w_t - s_t)}$$

The preference shock to consumption,  $\gamma_t$ , is an AR(1) stationary process  $\gamma_t = \rho_\gamma \gamma_{t-1} + \eta_{\gamma,t}$ . Setting  $\rho_1 \simeq 1$ ,  $\frac{C_t}{Y_t}$  is approximated as a random walk, so  $E_t \frac{Y_{t+i}}{C_{t+i}} = \frac{Y_t}{C_t}$  for all  $i > 0$ .<sup>36</sup> The expression becomes

$$\frac{A_{t+1}}{A_t} = a_1 \cdot \frac{\frac{\beta \rho_\gamma}{1 - \beta \rho_\gamma} \cdot \frac{Y_t}{C_t}}{\frac{w_t}{C_t} (1 - s'_t)}$$

where  $\frac{s_t}{w_t} \equiv s'_t$ ; see main model discussion.

### A.2. The labour supply response to subsidies

Taking the total derivative of the time endowment in 3 gives  $dx_t = -dN_t - dz_t$ , or  $\frac{dx_t}{x_t} = \frac{-dN_t - dz_t}{x_t}$ . Taking  $\bar{N} \approx \bar{x} \approx \frac{1}{2}$  in some initial steady state with approximately no  $z$  activity implies  $\frac{dx_t}{x_t} = d \ln x_t \approx -d \ln N_t - \frac{dz_t}{N} = -d \ln N_t - 2dz_t$ . Substituting into the loglinearised intratemporal condition using this and 24, we obtain

$$d \ln N_t - 2c_1 ds'_t = -\frac{1}{\rho_2} d \ln \xi_t + \frac{1}{\rho_2} d \ln \gamma_t - \frac{\rho_1}{\rho_2} d \ln C_t + \frac{1}{\rho_2} \left[ k + d \ln \tilde{w}_t - \frac{1}{\rho} \left[ \frac{1-\omega}{\omega} \right]^\sigma d \ln \varsigma_t - \left[ \frac{1-\omega}{\omega} \right]^\sigma d \ln Q_t \right]$$

Integrating and rearranging for the log of the real unit cost of labour to the firm,  $\ln \tilde{w}_t$ , gives expression  $\ln \tilde{w}_t = \text{const}_4 + \rho_2 \ln N_t + \rho_1 \ln C_t + \left[ \frac{1-\omega}{\omega} \right]^\sigma \ln Q_t - \rho_2 2c_1 s'_t + e_{w,t}$  (see main text).

## APPENDIX B: THE LINEARISED SYSTEM

<sup>35</sup> The non-policy cost of generating new productivity via  $z_t$  is assumed to be zero.

<sup>36</sup> Although in balanced growth  $\frac{C}{Y}$  is constant, in the presence of shocks the ratio will move in an unpredictable way (see Meenagh et al. 2007 for discussion).

The linearised system of optimality conditions and constraints solved numerically is given below. Each equation is normalised on one of the endogenous variables (constants are suppressed in the errors). Variables are in natural logs except where already expressed in percentages. For clarity,  $\ln(C_t^d)^*$  and  $\ln C_t^f$  are denoted  $\ln EX_t$  and  $\ln IM_t$ .

$$r_t = \rho_1 (E_t \ln C_{t+1} - \ln C_t) + e_{r,t} \quad (42)$$

$$\ln Y_t = \alpha \ln N_t + (1 - \alpha) \ln K_t + \ln A_t \quad (43)$$

$$\ln N_t = \ln Y_t - \tilde{w}_t + e_{n,t} \quad (44)$$

$$\ln K_t = \zeta_1 \ln K_{t-1} + \zeta_2 \ln K_{t+1} + \zeta_3 \ln Y_t - \zeta_4 r_t + e_{k,t} \quad (45)$$

$$\begin{aligned} \ln C_t = & \frac{\bar{Y}}{\bar{C}} \ln Y_t - \frac{EX}{\bar{C}} \ln EX_t + \frac{IM}{\bar{C}} \ln IM_t - \frac{\bar{K}}{\bar{C}} \ln K_t + \\ & (1 - \delta - \gamma_k) \frac{\bar{K}}{\bar{C}} \ln K_{t-1} - \frac{\bar{G}}{\bar{C}} \ln G_t \end{aligned} \quad (46)$$

$$\ln \tilde{w}_t = \rho_2 \ln N_t + \rho_1 \ln C_t + \left[ \frac{1 - \omega}{\omega} \right]^\sigma \ln Q_t + \rho_2 2c_1 s'_t + e_{wh,t} \quad (47)$$

$$\ln w_t = \ln \tilde{w}_t - \left[ \frac{1 - \omega}{\omega} \right]^\sigma \ln Q_t + e_{w,t} \quad (48)$$

$$\ln EX_t = \ln C_t^* + \sigma^F \frac{1}{\omega} \ln Q_t + e_{X,t} \quad (49)$$

$$\ln IM_t = \ln C_t - \sigma \ln Q_t + e_{M,t} \quad (50)$$

$$\ln Q_t = E_t \ln Q_{t+1} + r_t^f - r_t \quad (51)$$

$$\Delta \hat{b}_{t+1}^f = \frac{\tilde{b}^f}{1 + g} r_t^f + \frac{\tilde{r}^f}{1 + g} \hat{b}_t^f + \left( \frac{1}{1 + g} \right) \left( \begin{array}{c} \frac{EX}{\bar{Y}} \ln EX_t - \frac{EX}{\bar{Y}} \frac{1}{\omega} \ln Q_t \\ - \frac{IM}{\bar{Y}} \ln IM_t \end{array} \right) \quad (52)$$

$$\ln A_t = \ln A_{t-1} + b_1 s'_{t-1} + e_{A,t} \quad (53)$$

$$\ln C_t^* = \rho_{C^*} \ln C_{t-1}^* + \eta_{C^*,t} \quad (54)$$

$$\ln G_t = \rho_G \ln G_{t-1} + \eta_{G,t} \quad (55)$$

$$r_t^f = \rho_{rf} r_{t-1}^f + \eta_{rf,t} \quad (56)$$

$$s'_t = \rho_s s'_{t-1} + \eta_{s,t} \quad (57)$$

## APPENDIX C: DATA DEFINITIONS AND SOURCES

Most UK data are sourced from the UK Office of National Statistics (ONS); others from the International Monetary Fund (IMF), Bank of England (BoE), UK Revenue and Customs (HMRC) and Organisation for Economic Cooperation and Development (OECD). All data seasonally adjusted and in constant prices unless specified otherwise.

Symbol	Variable	Definition and Description	Source
$Y$	Output	Gross Domestic Product; constant prices.	ONS
$N$	Labour	Ratio of total employment to 16+ working population <sup>1</sup>	ONS
$K$	Capital Stock	Calculated from investment data (I) using Eqn.21	(na)
$I$	Investment	Gross fixed capital formation + changes in inventories	ONS
$C$	Consumption	Household final consumption expenditure by households	ONS
$A$	Total Factor Productivity	Calculated as the Solow Residual in Eqn. 18	(na)
$G$	Government Consumption	General government, final consumption expenditure	ONS
$IM$	Imports (also $C_t^f$ )	UK imports of goods and services	ONS
$EX$	Exports (also $C_t^{d*}$ )	UK exports of goods and services	ONS
$Q$	Terms of Trade	Calculated from $\frac{E.P_E}{P}$	(na)
$E$	Exchange Rate	Inverse of Sterling effective exchange rate	ONS
$P_F$	Foreign Price Level	Weighted av. of CPI in US (0.6), Germany (0.19) & Japan (0.21)	IMF
$P$	Domestic General Price Level	Ratio, nominal to real consumption	ONS
$b_F$	Net Foreign Assets	Ratio of nominal net foreign assets (NFA) to nominal GDP <sup>2</sup>	ONS
$w$	Consumer Real Wage	Average Earnings Index <sup>3</sup> divided by $P_t$	ONS
$\tilde{w}$	Unit cost of labour	Average Earnings Index <sup>3</sup> divided by GDP deflator	ONS
$r$	Real Interest Rate, Domestic	Nominal interest rate minus one period ahead inflation.	(na)
$R$	Nominal Interest Rate, Domestic	UK 3 month treasury bill yield	BoE
$r_F$	Real Interest Rate, Foreign	$R_F$ minus one-period ahead inflation (year-on-year change in $P_F$ )	(na)
$R_F$	Nominal Interest Rate, Foreign	Weighted av., 3-month discount rates, US, Germany & Japan <sup>4</sup>	IMF
$C_F$	Foreign Consumption Demand	World exports in goods and services	IMF
$s$	R&D Subsidy, Direct	BERD funded by government as proportion of total BERD	OECD

TABLE 7  
Data Description

Notes to Table:

<sup>1</sup> Working population is total claimant count plus total workforce jobs.

<sup>2</sup> Nominal NFA is accumulated current account surpluses (£m), taking the Balance of Payments international investment position as a starting point.

<sup>3</sup> AEI for whole economy including bonuses.

<sup>4</sup> Weights as for  $P^F$ . Germany proxies EU.

BERD is Business Enterprise R&D.

## APPENDIX D: AUXILIARY MODEL

The full linearised structural model, comprising a  $p \times 1$  vector of endogenous variables  $y_t$ , a  $r \times 1$  vector of expected future endogenous variables  $E_t y_{t+1}$ , a  $q \times 1$  vector of non-stationary variables  $x_t$  and a vector of i.i.d. errors  $e_t$ , can be written in the general form

$$A(L)y_t = BE_t y_{t+1} + C(L)x_t + D(L)e_t \quad (58)$$

$$\Delta x_t = a(L)\Delta x_{t-1} + d + b(L)z_{t-1} + c(L)\epsilon_t \quad (59)$$

$x_t$  is a vector of unit root processes, elements of which may have a systematic dependency on the lag of  $z_t$ , itself a stationary exogenous variable (this variable is subsumed into the shock below).  $\epsilon_t$  is an i.i.d., zero mean error vector. All polynomials in the lag operator have roots outside the unit circle. Since  $y_t$  is linearly dependent on  $x_t$  it is also non-stationary. The general solution to this system is of the form

$$y_t = G(L)y_{t-1} + H(L)x_t + f + M(L)e_t + N(L)\epsilon_t \quad (60)$$

where  $f$  is a vector of constants. Under the null hypothesis of the model, the equilibrium solution for the endogenous variables is the set of cointegrating relationships (where  $\Pi$  is  $p \times p$ )<sup>37</sup>:

$$y_t = [I - G(1)]^{-1}[H(1)x_t + f] \quad (61)$$

$$= \Pi x_t + g \quad (62)$$

though in the short run  $y_t$  is also a function of deviations from this equilibrium (the error correction term  $\eta_t$ ):

$$y_t - (\Pi x_t + g) = \eta_t \quad (63)$$

In the long run, the level of the endogenous variables is a function of the level of the unit root variables, which are in turn functions of all past shocks.

$$\bar{y}_t = \Pi \bar{x}_t + g \quad (64)$$

$$\bar{x}_t = [1 - a(1)]^{-1}[dt + c(1)\xi_t] \quad (65)$$

$$\xi_t = \sum_{s=0}^{t-1} \varepsilon_{t-s} \quad (66)$$

Hence the long-run behaviour of  $\bar{x}_t$  can be decomposed into a deterministic trend part  $\bar{x}_t^D = [1 - a(1)]^{-1}dt$  and a stochastic part  $\bar{x}_t^S = [1 - a(1)]^{-1}c(1)\xi_t$ , and the long run behaviour of the endogenous variables is dependent on both parts. Hence the endogenous variables consist of this trend and of deviations from it; one could therefore write the solution as this trend plus a VARMA in deviations from it. An alternative formulation is as a cointegrated VECM with a mixed moving average error term

$$\Delta y_t = -[I - G(1)](y_{t-1} - \Pi x_{t-1}) + P(L)\Delta y_{t-1} + Q(L)\Delta x_t + f + \omega_t \quad (67)$$

$$\omega_t = M(L)e_t + N(L)\varepsilon_t \quad (68)$$

which can be approximated as

$$\Delta y_t = -K[y_{t-1} - \Pi x_{t-1}] + R(L)\Delta y_{t-1} + S(L)\Delta x_t + h + \zeta_t \quad (69)$$

---

<sup>37</sup>In fact the matrix  $\Pi$  is found when we solve for the terminal conditions on the model, which constrain the expectations to be consistent with the structural model's long run equilibrium.

or equivalently, since  $\bar{y}_{t-1} - \Pi\bar{x}_{t-1} - g = 0$ ,

$$\Delta y_t = -K[(y_{t-1} - \bar{y}_{t-1}) - \Pi(x_{t-1} - \bar{x}_{t-1})] + R(L)\Delta y_{t-1} + S(L)\Delta x_t + m + \zeta_t \quad (70)$$

considering  $\zeta_t$  to be i.i.d. with zero mean. Rewriting equation 69 as a levels VARX(1) we get

$$y_t = [I - K]y_{t-1} + K\Pi x_{t-1} + n + \phi t + q_t \quad (71)$$

where the error  $q_t$  now contains the suppressed lagged difference regressors, and the time trend is included to pick up the deterministic trend in  $\bar{x}_t$  which affects both the endogenous and exogenous variables.  $x_{t-1}$  contains unit root variables which must be present to control for the impact of past shocks on the long run path of both  $x$  and  $y$ . This VARX(1) approximation to the reduced form of the model is the basis for the unrestricted auxiliary model used throughout the estimation.

## APPENDIX E: VARIANCE DECOMPOSITION (ALL VARIABLES)



	$r$	$Y$	$N$	$K$	$C$	$w$	$\tilde{w}$	$X$	$M$	$Q$	$b^F$	$A$	$d(A)$
Shock to $r$	0.16915	0.00197	0.00946	0.01392	0.04238	0.03864	0.00063	0.01232	0.06000	0.01156	0.03056	0	0
Shock to TFP	0.23125	0.34965	0.22750	0.21159	0.23919	0.11268	0.35403	0.31997	0.14627	0.30031	0.01221	0.37125	0.90164
Shock to $N$	0.03092	0.00198	0.01529	0.00104	0.00167	0.02777	0.01385	0.00073	0.00006	0.00069	0.00074	0	0
Shock to $K$	0.16036	0.02454	0.04456	0.41922	0.02423	0.01442	0.01927	0.01438	0.00731	0.01350	0.01233	0	0
Shock to $w$	0.12176	0.01992	0.16159	0.01146	0.01462	0.03621	0.00125	0.00653	0.00058	0.00613	0.00491	0	0
Shock to $X$	0.03448	0.01006	0.10313	0.00026	0.16463	0.44235	0.00103	0.10006	0.37763	0.14460	0.65353	0	0
Shock to $M$	0.02802	0.00123	0.01439	0.00062	0.02004	0.03956	0.00022	0.01404	0.09832	0.01318	0.05384	0	0
Subsidy shock	0.14243	0.58885	0.40561	0.33892	0.41954	0.15387	0.60936	0.50078	0.17308	0.47001	0.09621	0.62875	0.09836
$C^F$ shock	0.00527	0.00159	0.01643	0.00006	0.06412	0.11844	0.00017	0.02681	0.12097	0.03590	0.13144	0	0
$r^F$ shock	0.07095	0.00009	0.00053	0.00285	0.00928	0.01594	0.00016	0.00423	0.01577	0.00397	0.00392	0	0
$G$ shock	0.00539	0.00012	0.00150	0.00006	0.00030	0.00014	0.00002	0.00013	0.00001	0.00013	0.00031	0	0

TABLE 8  
Variance Decomposition, Subsidy Model 1

		Starting calibration
CRRRA coefficient ( $C_t$ )	$\rho_1$	1.0
CRRRA coefficient ( $x_t$ )	$\rho_2$	1.2
Preference weight on $C_t$	$\theta_0$	0.5
Home bias in consumption	$\omega$	0.7
Foreign equivalent of $\omega$	$\omega^F$	0.7
Import demand elasticity	$\sigma$	1.0
Elasticity of substitution ( $C_t^{d*}, C_t^{f*}$ )	$\sigma^F$	0.7
Capital equation coefficients <sup>38</sup>	$\zeta_1, \zeta_2, \zeta_3, \zeta_4$	0.51, 0.47, 0.02, 0.25
$\frac{\partial R \& D_t}{\partial s'_t}$	$c_1$	0.06
$\frac{\partial [d \ln A_{t+1}]}{\partial s'_t}$	$b_1$	0.1
Wald percentile		100

TABLE 9

Initial set of structural model parameters, based on Meenagh et al. (2010)

## APPENDIX F: INITIAL STRUCTURAL PARAMETER SET

The structural parameter set in Table 9 based on Meenagh et al. (2010) was used to initiate the Indirect Inference estimation process, which searched over points in the parameter space defined by the 30% bounds around these values (see Section 4.4). Table 10 gives the implied AR(1) coefficients for the exogenous variables.

Exogenous variable	AR coefficient	Starting calibration
Shock to real interest rate	$\rho_r$	0.860
Shock to $TFP$	$\rho_A$	0.589
Shock to labour demand	$\rho_N$	0.897
Shock to capital demand	$\rho_K$	0.765
Shock to real wage	$\rho_{\tilde{w}}$	0.879
Shock to export demand	$\rho_X$	0.939
Shock to import demand	$\rho_M$	0.848
Shock to R&D subsidy	$\rho_S$	0.974
Shock to foreign consumption demand	$\rho_{CF}$	0.939
Shock to foreign real interest rate	$\rho_{rF}$	0.851
Shock to government consumption	$\rho_G$	0.972

TABLE 10  
Starting AR coefficients for stationary exogenous variables